City University Research Journal
Special Issue: AIC, Malaysia PP 14-20

THE IMPACT OF CORPORATE GOVERNANCE ON FINANCIAL PERFORMANCE OF PAKISTAN'S CEMENT MANUFACTURING FIRMS

Mahboob Ullah
Peshawar Business School, University Town, Peshawar, Pakistan
PhD Scholar, Preston University, Islamabad, Pakistan
mahboobmails@gmail.com

Dr. Nouman Afgan
Preston University, Islamabad, Pakistan
nouman.afgan@preston.edu.pk

Muhammad Hashim
Government College of Management Sciences Peshawar, Ph.D. Scholar Preston University, Islamabad, Pakistan
Research Fellowship School of Management, Universiti Sains Malaysia, Malaysia
mhashimpk001@gmail.com

Dr. Muhammad Azizullah Khan
Preston University, Islamabad, Pakistan
azizpakpost@yahoo.com

Abstract

Good corporate governance instills investors' trust in the financial market. Good governance creates goodwill, enhances firm financial performance but if the companies are governed poorly then they lose confidence of each stakeholder due to suboptimal financial performance. The main objective of this research study is to analyze the impact of corporate governance on financial performance of cement sector firms on the Pakistan Stock Exchange (PSX). For accomplishment of research objective, 20 cement sectors firms listed on the PSX, Pakistan, constituting 83% of the entire cement industry was used from year 2005 to 2014. Hypotheses were tested using correlation and regression analysis. Corporate governance is measured through the fraction of insider directors, institutional shareholdings and board independence. Whereas, return on assets and return on equity is used to measure financial performance. The findings reveal that corporate governance positively effects financial performance. This study not only contributes to understanding the effect and relationship between corporate governance and financial performance but at the same time proves the results of earlier research work that have shown a significant effect and relationship between corporate governance and financial performance.

Key words: Corporate Governance, Financial Performance, Pakistan Stock Exchange

1. Introduction

Corporate governance is one of the key areas of business which enhances the courage of investors and allow for protecting their interest. The significance of corporate governance is realized by the investors, corporations and governments for competing domestically and internationally (Owen, 2003). In academic researches, corporate governance has got great concentration in developed and developing countries (Mallin, 2004; Reed, 2002; Solomon & Solomon, 2004; Weir & Laing, 2001). A need was felt for sound corporate governance practices especially in

© 2017 CURJ, CUSIT

developing countries due to financial scandals in past (Baydoun, Maguire, Ryan & Willett, 2013). Great consideration has been devoted to corporate governance in under-developed economies as many of these lacks appropriate corporate governance practices (Ekanayake, Perera & Perera, 2010).

Corporate governance is important for economic development of Pakistan as it plays a key role in economic growth of a country. The Securities and Exchange Commission of Pakistan (SECP) has centered its regulatory measures in promoting investors confidence to uphold sound corporate governance to make sure transparency and accountability in the corporate sector and protect all stakeholders particularly minority stakeholders. Code of corporate governance for Pakistan was issued by SECP in March 2002 and it was included in the listing regulations of firms in PSX.

All the firms strive to attract corporate investors in national and global financial market by paying maximum amount of wealth on invested capital. Wealth maximization occurs when stock price is increased for current shareholders. Maximization of shareholders wealth is the primary goal of every firm (Van Horne & Harlow, 2009). The goal of shareholders and other corporate stakeholders including lenders, employee, business associates, society at large and government is accomplished if there exists sound governance in companies. If companies are governed poorly, will face poor financial performance (Hashim, Khattak & Kee, 2017). It is believed that practice of corporate governance is an internal mechanism for operation of corporations. It can instill investors' confidence and effect corporate financial performance. According to Ghabayen, (2012) corporate governance is a useful tool for guaranteeing excellent performance.

This research is conducted for analyzing the impact of corporate governance on financial performance of cement sector firms listed on PSX from year 2005 to 2014. Insider directors, institutional shareholdings and board independence are used as the facets of corporate governance, whereas, financial performance is measured through return on assets and return on equity.

2. Literature Review

It is imperative for business organizations to generate maximum profit in order to survive, compete and grow in the market. Profit maximization is the primary goal of every business firm which can be accomplish by applying sound corporate governance practices. If firms will distribute sound amount of dividend amongst current shareholders, on time payment to creditors and government agencies, protect the interest of employees and act as good citizen by applying good corporate governance mechanism then firms can instill confidence of all stakeholders. Corporate governance has traditionally been related with the principal and agent or agency conflict. Principal and agent relationship occurs when those who own a firm is not alike as those who manages or controls the firm. Agency theory has its heredity in theories of economic, developed by Jensen and Meckling in 1976. The theory of Agency states that shareholders (principal) who are real owners of corporations assign the operation of corporation to managers (agents). The principals anticipate that agents will work in the best interest of corporation and will make decisions which will increase firm's value. However, the interest of agents may diverge from principal.

Corporate governance plays a vital role in accomplishment of organizational goal across the globe due to emergence of markets, trade liberalization, financial crises, capital mobility and technological advancement. Corporate governance is considered as mainstream concern in structure of corporation in corporate board in all business (Claessens, Djankov & Lang, 2000). According to Edwards & Nibler, (2000) corporate governance systems perform a significant role in financial performance as they present mechanism which effect investment's return for suppliers of finance to corporation. Nestor and Thompson, (2000) have categorized these systems into two kinds: Anglo Saxon Model and Continental Model. Anglos Saxon Model inclined to depend on managers' compensation for corporate control, whereas, Continental Model inclined to rely on several stockholders to support the managers and owners behavior. The Anglo Saxon model is based on concept that ownership stake and decentralized market can perform in a self-controlled, balanced manner and is founded on notion of capitalism market (Cernat, 2004). Therefore,

corporations have normally same systems of corporate governance in Anglo American countries: UK, US, Australia and Canada. In this model, management activities are monitored and controlled by one independent board of directors for maximizing wealth of shareholders. The Continental Model of corporate governance focus on analyzing on the stakes of crew, managers, clients, suppliers and community, which aid innovations and competitions (Giurca Vasilescu, 2008; Hashim, 2014).

The code of corporate governance was firstly notified in 2002 in made compulsory for listing of companies on stock exchange(s) in Pakistan. Corporate stakeholders are affected by the financial performance. The stake of each stakeholder mostly clash with the interest of other. Amongst them only few stakeholders possess more control in decision making. A system is needed which can serve and protect the individual and collective stake of each stakeholder and protect exploitation of each stakeholders interest and from the monopoly of individual stakeholder in decision making. Corporate governance is the system used for attaining the individual and corporate stake (Butt, 2012). According to the Organization for Economic Cooperation and Development (OECD) principles of corporate governance, (2015) corporate governance is the amalgamation of relationship in shareholders, board, management and rest of stakeholders. According to Audit Commission, (2009) and Chartered Institute of Public Finance and Accountancy and the Society of Local Authority Chief Executives, (2007) emphasize the essential component of accountability and controlling in corporate governance. The fundamental objective of corporate governance measure is to direct and control in order to bring transparency in corporations which in return effect financial performance of companies. Financial performance is subjective gauge of how efficiently an organization could utilize entire resources to produce income. Financial performance could be use a common measure of the entire financial situation during particular time period and could be use to evaluate same firms across the similar industry or to evaluate aggregate sector. Barbosa and Louri, (2005) applied return on assets, earning per share, sales growth, market capitalization and dividend earning to measure financial performance. (Davies, Hillier & McClogan, 2005; Kapopoulos & Lazaretou, 2009) support the fact that insider directors directly effect firm financial performance of firm. Giving equity ownership to managerial shareholders will improve financial performance of firm (Hashim & Hameed, 2012; Qureshi et al., 2010).

Pound, (1988) analyzed institutional ownership and its effects on financial performance of the firm and proposed that Efficient Monitoring hypothesis enhances financial performance of the firm. Berle and Means, (1991) suggested that institutional shareholdings reduce cost of transaction as well as it removes agency problem to a great extent. Hermalin and Weisbach (2001) identified that more improvement in profitability is achieved by firms with more independent directors, which in turn enhance financial performance of firm. Javed and Iqbal, (2006) conducted a study to appraise corporate governance and financial performance of fifty non financial firms, including more than 80% of market capitalization listed at Karachi Stock Exchange, Pakistan. They conclude that there is a positive and significant relationship between corporate governance and financial performance of firms. Good corporate governance leads to sound financial performance (Drobetz, Shillhofer & Zimmermann, 2003; Hashim, 2013).

The core purpose of this research is to evaluate the impact of corporate governance on financial performance of cement sector firms listed on PSX and suggests measures to improve corporate governance practices to maximize financial performance.

2.1 Hypotheses

The corporate governance system is weak in Pakistan. This implies the following hypotheses:

H_1: Insider directors positively effects financial performance of cement sector firms.

H_2. Institutional shareholdings have affirmative impact on financial performance of cement sector firms.

H_3. Board independence effects positively financial performance of cement sector firms.

3. Data

© 2017 CURJ, CUSIT

The sample selected comprises of 20 cement manufacturing firms listed on the PSX, Pakistan from the year 2005 to 2014. Our sample accounts for 83 percent of the entire market capitalization of cement industry. Descriptive research design is employed which involves the collection, analyses and modeling of data to analyze the hypothesized relationship among these variables. The data collected regarding corporate governance, financial performance and risk is scrutinized using descriptive statistics: mean and standard deviation and Pearson Product Moment correlation analysis. The statistical package, Stata 13 is used to perform the analysis.

3.1 Descriptive Statistics of the Variables

Following Table 1 reports descriptive statistics of the variables.

Table 1: Internal Consistency and Reliability (N=200)

Variables	Mean	Std. Dev	Min	Max
Insider Directors	0.55	0.25	0.00	3.97
Institutional Shareholdings	0.23	0.22	0.00	0.77
Board Independence	0.16	0.32	0.00	1.00
Return on Assets	0.22	0.07	0.17	3.13
Return on Equity	0.28	0.15	0.25	2.09

3.2 Correlation Analysis

3.2.1 Corporate Governance and Financial Performance

Return on assets and corporate governances. The correlation analysis reports that fraction of insider directors, institutional shareholdings and board independence are positively correlated with return on assets.

Table 2: Correlation Analysis: Return on Assets and Corporate Governance Variables

	ROA	ID	IDR	BI
Insider Directors	0.23			
Institutional Shareholdings	0.02	-0.04		
Board Independence	0.31	-0.04	0.13	1.00

Note. ROA= Return on Assets, ID= Insider Directors, IS= Institutional Shareholdings and BI= Board Independence

Return on equity and corporate governance. The correlation analysis reports that insider directors, institutional shareholdings and board independence are positively correlated with return on equity.

Table 3: Correlation Analysis: Return on Equity and Corporate Governance Variables

	ROE	ID	IS	BI
Insider Directors	0.25			
Institutional Shareholdings	0.07	-0.08		
Board Independence	0.28	-0.07	0.15	
Audit Committee	0.08	-0.07	-0.02	1.00

Note. ROE= Return on Equity, ID= Insider Directors, IS= Institutional Shareholdings and BI= Board Independence

4. Analysis and Discussions

4.1 Corporate Governance and Financial Performance

Corporate governance and return on assets. The regression results are robust and adjusted R-square is 0.32. The result indicates that fraction of insider directors, institutional shareholdings and board independence positively affect return on assets. Insider directors enhance financial performance of firm (Kapopoulos & Lazaretou, 2009). There is evidence of the Efficient Monitoring hypothesis that predicts that institutional shareholdings improve financial performance of firm (Pound, 1988). Hermalin and Weisbach, (2001) identify that more improvement in profitability is accomplished by the firms with high fraction of independent directors on the board.

Table 4: Regression Analysis: Corporate Governance and Return on Assets

	Coef.	Std. Err.	t	P>|t|	[95% Conf. Interval]	
Insider Directors	0.02	0.01	2.04	0.05	0.06	0.08
Institutional Shareholdings	0.02	0.32	1.93	0.45	-0.65	0.65
Board Independence	0.09	0.12	2.08	0.39	0.33	0.13
	Number of observations	=	200			
	F Value	=	5.45			
	P Value	=	0.00			
	Adjusted R-squared	=	0.32			

Corporate governance and return on equity. The regression results are robust. The result indicates that fraction of insider directors, institutional shareholdings and board independence effect return on equity. Insider directors enhance financial performance of firm (Kapopoulos & Lazaretou, 2009). There is evidence of the Efficient Monitoring hypothesis that predicts that institutional shareholdings positively affect financial performance of firm (Pound, 1988). Hermalin and Weisbach, (2001) identify that more improvement in profitability is accomplished by the firms with high fraction of independent directors on the board.

Table 5: Regression Analysis: Corporate Governance and Return on Equity

	Coef.	Std. Err.	t	P>|t|	[95% Conf. Interval]	
Insider Directors	0.02	0.01	2.32	0.01	0.04	0.02
Institutional Shareholdings	0.03	0.26	1.02	0.02	0.55	0.45
Board Independence	0.21	0.14	2.02	0.05	0.02	0.42
	Number of observations	=	200			
	F Value	=	7.54			
	P Value	=	0.00			
	Adjusted R-squared	=	0.37			

5. Conclusion

This research study finds evidence that corporate governance positively effects firms' performance of cement sector firms listed on PSX. The result indicates that financial performance is highly affected due to corporate governance. The corporate governance measures enhance the performance of cement manufacturing firms listed on PSX. There is considerable evidence of the hypothesis that corporate governance positively influences financial performance of firm. The empirical analyses provide evidence in support of the hypothesis. The results also indicate that all the facets of corporate governance positively effects financial performance.

© 2017 CURJ, CUSIT

The analysis reveals that corporate governance plays a vital role in order to enhance firm performance. The fraction of independent director(s) in the board and audit committee positively affects the financial performance of cement manufacturing firms. The fraction of insider directors enhances financial performance of firm (Kapopoulos and Lazaretou, 2009). There is evidence of the Efficient Monitoring Hypothesis that predicts that institutional shareholdings increases financial performance of firm (Pound, 1988). Hermalin and Weisbach (2001) identify that more improvement in profitability is accomplished by corporations with more independent directors. There is ample empirical evidence on corporate governance and financial performance of firms and the findings of the current study support the previous researchers' work (Brown & Caylor, 2004; Mitton, 2001; Harmilalin & Weisbach, 2003; Rafi, Kazmi & Hashim, 2014).

References

Barbosa, N., & Louri, H. (2005). Corporate performance: does ownership matter? a comparison of foreign and domestic owned firms in Greece and Portugal. *Review of Industrial Organization*, 27(1), 73-102.

Baydoun, N., Maguire, W., Ryan, N., & Willett, R. (2013). Corporate governance in five Arabian Gulf countries, *Managerial Auditing Journal*, 28 (1), 7–22.

Berle, A. A., & Means, G. G. C. (1991). *The modern corporation and private property*. Transaction publishers.

Butt, A. S. (2012). *Corporate governance for Pakistan (4th edition)* Azeem Academy.

Cernat, L. (2004). The emerging European corporate governance model: Anglo-Saxon, Continental, or still the century of diversity? *Journal of European Public Policy*, 11(1), 147-166.

Chartered Institute of Public Finance and Accountancy and the Society of Local Authority

Chief Executives (2007). Corporate governance in local government: a keystone for community governance, Chartered Institute of Public Finance and Accountancy and the Society of Local Authority Chief Executives, Online available: http://secure.cipfa.org.uk/cgi-bin/CIPFA. storefront/EN/product/BU012 (12th October 2010).

Claessens, S., Djankov, S., & Lang, L. H. (2000). The separation of ownership and control in East Asian corporations. *Journal of financial economics*, 58 (1), 81-112.

Davies, J. R., Hillier, D., & Mc Colgan, P. (2005). Ownership structure, managerial behavior and corporate value. *Journal of Corporate Finance*, 11(4), 645-660.

Drobetz, W., Schillhofer, A., & Zimmermann, H. (2003). Corporate governance and expected stock returns: Evidence from Germany. *Working Paper,* University of Basel.

Edwards, J., & Nibler, M. (2000). Corporate governance in Germany: the role of banks and ownership concentration. *Economic Policy*, 15 (31), 237-267.

Ekanayake, A., Perera, H., & Perera, S. (2010). Contextual relativity of the role of accounting in corporate governance: evidence from the banking industry in Sri Lanka. *The Sixth Asia Pacific Interdisciplinary Research in Accounting Conference, Sydney*, 1-27,

Ghabayen, M. A. (2012). Board characteristics and firm performance: Case of Saudi Arabia. *International Journal of Accounting and Financial Reporting*, 2 (2), 168-200.

Giurca Vasilescu, L. (2008). Corporate governance in developing and emerging countries: the case of Romania. *Munich Personal RePEc Archive, http://mpra.ub.uni-muenchen.de/11053/.*

Hashim, M. (2014). Organizational change: Case study of GM (General Motor). *Journal of Business Administration and Management Sciences Research*, *3*(1), 001-005.

Hashim, M. (2013). Change management. International Journal of Academic Research in Business and Social Sciences, 3(7), 685.

Hashim, M., & Hameed, F. (2012). Human resource management in 21st century: issues & challenges & possible solutions to attain competitiveness. International Journal of Academic Research in Business and Social Sciences, 2(9), 44.

Hashim, M., Khattak, M. A., & Kee, D. M. H. (2017). Impact of Servant Leadership on Job Satisfaction: A Study of Teaching Faculty in Universities of Peshawar. Abasyn Journal of Social Sciences

Hermalin, B. E., & Weisbach, M. S. (2001). Board of directors as endogenously determined institution: a survey of the literature. *Economic Policy Review.*

© 2017 CURJ, CUSIT

Javed, Y. A., & Iqbal, R. (2006). Corporate governance and firm performance: evidence from Karachi Stock Exchange. *The Pakistan Development Review,* 45(4), 947-964.
Jensen, C. M., & Meckling, H. W. (1976). Theory of the firm: managerial behavior, agency costs and ownership structure. *Journal of Financial Economics,* 3(4), 305-360.
Kapopoulos, T. P., & Lazaretou, S. (2009). Corporate ownership structure and firm performance: evidence from Greek Firms. *Working Paper* (Bank of Greece No. 37). Greece: Bank of Greece.
Mallin, C. A. (2004). *Corporate governance*, 1th edn, Oxford University Press, Incorporated.
Nestor, S., & Thompson, J. (2000). Corporate governance patterns in OECD economies: is convergence under way?. OECD (2001), *Corporate governance in Asia: A comparative perspective*, 19-41, OECD, Paris.
OECD Principles of corporate governance (2015). www.oecd.org/daf/ca/Corporate- Governance- Principles-ENG.pdf
Owen. J. (2003). The Failure of HIH Insurance: A corporate collapse and its lessons, Common wealth of Australia. *HIH Royal Commission Report*, Speech to 13th common wealth Law Conference, 1.
Pound, J. (1992). Beyond takeovers: politics comes to corporate control, *Harvard Business Review,* 70 (2), 83-94.
Qureshi, M. I., Zaman, K., & Shah, I. A. (2010). Relationship between rewards and employee's performance in the cement industry in Pakistan. *Journal of international academic research*, 10(2), 19-29.
Rafi, B., Kazmi, S. S. A., and Hashim , M. (2014). Validity of FAMA and French Model: Evidence from KSE-100 index. *International Journal of Management Science 1*(3): 52-57
Reed, D. (2002). Corporate governance reforms in developing countries. *Journal of Business Ethics*, 37 (3), 223-247.
Solomon, J., & Solomon, A. (2004). *Corporate governance and accountability*, John Wiley, New York, NY.
Van Horne, C. J., & Harlow, W. M. J. (2009). *Fundamentals of Financial Management (13th Edition).* FT Prentice Hall.
Weir, C., Laing, D., & McKnight, P. (2002). Internal and external governance mechanisms: their impact on the performance of large UK public companies. *Journal of business finance and accounting,* 29, 579-611.

APPENDIX: DEFINITIONS

Corporate Governance Variables

Insider Directors. The number of shareholders who participate in the management of the corporation.
Institutional Shareholdings. Percentage of shares owned by outside institutional stockholders.
Board Independence. Number of independent directors in the board.

Financial Performance Variables

Return on Assets. Net income with total assets: Net Income / Total Assets.
Return on Equity. Net income with total shareholders' equity: Net Income / Total Shareholders' equity.